DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER: 02-0498
ADJUSTED GROSS INCOME TAX
FOR THE YEARS 1998, 1999, 2000

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ISSUES

I. Adjusted Gross Income Tax-Throwback sales

Authority: IC § 6-3-1-3.5; IC § 6-3-2-1; IC § 6-3-2-2; IC § 6-8.1-5-1(b); 45 IAC 1-1-119 45 IAC 3.1-1-53; 45 IAC 3.1-1-64; Public Law 86-272 (15 USCS § 381); *Wisconsin Department of Revenue v. William Wrigley, Jr. Co.*, 505 U.S. 214; 112 S. Ct. 2447; 120 L.Ed.2d 174 (1992)

Taxpayer protests the Department's assessment of additional gross income tax on sales the audit determined should be thrown back to Indiana.

II. Tax Administration-Reliance and retroactivity

Authority: 45 IAC 15-3-2; Tax Policy Directive #9

Taxpayer protests the Department's assessment of additional adjusted gross income tax on sales the audit determined should be thrown back to Indiana. A prior Letter of Findings for this taxpayer had determined sufficient nexus existed to prevent throwback sales.

III. Adjusted Gross Income Tax-Numerator of property factor

Authority: 45 IAC 3.1-1-44.

Taxpayer protests the change to the denominator of the property factor without a concomitant change in the numerator, alleging that such failure to change the numerator distorts taxpayer's tax liability.

STATEMENT OF FACTS

The taxpayer distributes electronic equipment throughout the United States, Canada, and Latin America. In addition to distribution activities, taxpayer is also responsible for marketing and servicing its products in North and South America. The taxpayer has three divisions: Branded products, original equipment manufacturer products (OEM), and customer service and support. The branded products division offers products such as printers, scanners, and personal computers. The OEM division supplies a wide range of OEM products throughout North, Central, and South America. The products marketed by OEM include integrated chips, floppy disks, memory cards, and power supplies. The customer service and support division provides support for customers both before and after the sale. Customer support handles customer relation issues, warranty administration, and technical assistance.

The taxpayer agrees that the Department's adjustment of adjusted gross income tax for state income taxes, property taxes, and charitable contributions was correct. The taxpayer also agrees to the property factor adjustment for rent expenses and inventory. The only issue still in protest is whether or not the adjustment for throwback sales was proper. Taxpayer was sustained in a previous Letter of Findings on the same issue.

Additional facts will be provided below as necessary.

I. Adjusted Gross Income Tax-Throwback sales

DISCUSSION

Under IC § 6-8.1-5-1(b), a "notice of proposed assessment is *prima facie* evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made."

IC § 6-3-1-3.5, subsection (b), defines "adjusted gross income" for corporations as "the same as 'taxable income' (as defined in Section 63 of the Internal Revenue Code)" with four adjustments not at issue here. IC § 6-3-2-1 establishes the rate of the tax imposed on adjusted gross income; IC § 6-3-2-2 defines "adjusted gross income derived from sources in Indiana." Subsection (n) states that a "taxpayer is taxable in another state if:

> (1) in that state the taxpayer is subject to a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business, or a corporate stock tax; or
> (2) that state has jurisdiction to subject the taxpayer to a net income tax regardless of whether, in fact, the state does or does not.

With respect to Indiana's adjusted gross income tax statute, 45 IAC 3.1-1-53 provides in pertinent part:

> When Sales of Tangible Personal Property Are in This State. Gross receipts from the sales of tangible personal property (except sales to the United States

> Government—See Regulation 6-3-2-2(e)(050) *[45 IAC 3.1-1-54]* are in this state: (a) if the property is delivered or shipped to a purchaser within this state regardless of the F.O.B. point or other conditions of sales; or (b) if the property is shipped from an office, store, factory, or other place of storage in this state, and the taxpayer is not taxable in the state of the purchaser.

Subsection (5) provides in pertinent part:

> If the taxpayer is not taxable in the state of the purchaser, the sale is attributed to this state if the property is shipped from an office, store, warehouse, factory, or other place of storage in this state. Such sale is termed a "Throwback" sale.

45 IAC 3.1-1-64 defines "taxable in another state" as "when such state has jurisdiction to subject it to a net income tax. This test applies if the taxpayer's business activities are sufficient to give the state jurisdiction to impose a net income tax under the Constitution and laws of the United States. **Jurisdiction to tax is not present where the state is prohibited from imposing the tax by reason of the provision of Public Law 86-272, 15 U.S.C.A. § 381-385.**" **(Emphasis added).**

Public Law 86-272 provides in pertinent part:

> No State . . . shall have power to imposes, for any taxable year. . . , a net income tax on the income derived within such State by any person from interstate commerce if the only business activities within such State by or on behalf of such person during such taxable year are either, or both, of the following:
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> (1) the solicitation of orders by such person, or his representative, in such State for sales of tangible personal property, which orders are sent outside the State for approval or rejection, and, if approved, are filled by shipment or delivery from a point outside the State; and
> (2) the solicitation of orders by such person, or his representative, in such State in the name of or for the benefit of a prospective customer of such person, if orders by such customer to such person to enable such customer to fill orders resulting from such solicitation are orders described in paragraph (1)

15 USCS § 381(a).

The United States Supreme Court, in *Wisconsin Department of Revenue v. William Wrigley, Jr. Co.,* 505 U.S. 214, 112 S.Ct. 2447, 120 L.Ed.2d 174 (1992), construed the above statutory language to hold that a business's in-state activities could subject it to that state's taxing jurisdiction if those activities involved more than the "mere solicitation of orders" and more than *de minimis* contact in connection with the solicitation of orders. The Court set forth a method of analysis by which to determine whether or not a business's in-state activities cause it to lose the

tax immunity 15 USCS § 381 confers: "Section 381 was designed to increase . . . the connection that a company could have with a State before subjecting itself to tax. Accordingly, whether in-state activity other than 'solicitation of orders' is sufficiently *de minimis* to avoid loss of the tax immunity conferred by § 381 depends upon whether that activity establishes a nontrivial additional connection with the taxing State." Unless activities are "ancillary to" ordering product or *de minimis*, then a business can be taxed in another jurisdiction without that jurisdiction violating § 381.

The previous LOF issued to the taxpayer stated that it was not required to "throwback" sales to the numerator of the sales factor in its consolidated return because the taxpayer had nexus in the states where the sales were made. The previous LOF did not specifically address the significance of the fact that the sales at issue were made by a member of the affiliated group that did not have nexus in the states at issue, but another member of the affiliated group, the parent company, did have nexus in those states. Electing to file a consolidated return does not change the rules for attributing sales to the numerator of the sales factor. Since the attribution of such sales is done prior to the aggregation of those sales into the consolidated factor, only those tax attributes of the member are relevant.

The audit report assumes that the previous LOF was based on a unitary analysis relating to a combined return. Whether this is true or not, it is incorrect and irrelevant. The taxpayer has not petitioned to file a combined return and the Department is not attempting to require such a return. Therefore, concepts and analysis in making such a determination in the context of a combined filing are inapplicable. The previous LOF was incorrect and the taxpayer is required to throwback those sales made by members of the affiliated group into states in which the member did not have nexus, even though another member of the group did have nexus in that state.

FINDING

The taxpayer's protest concerning the issue of throwback sales is denied.

II. Adjusted Gross Income Tax-Reliance, and retroactivity

DISCUSSION

Taxpayer's protest is based on the extent to which taxpayer may rely on a Departmental Ruling issued as to its particular set of facts and circumstances, and the extent to which the Department may retroactively change the application of a prior Ruling involving the same taxpayer, facts, and issues. The auditor stated in the Audit Summary for tax years 1998, 1999 and 2000 that there have been no changes in the facts since the issuance of the prior Letter of Findings. That Letter of Findings did not, as the auditor alleged, rely on case law that has since been discredited. There is no mention of cases explicating unitary filings, i.e., *Finnegan*. The prior Letter relied on statutes, regulations, and a United States Supreme Court case, *Wisconsin Department of Revenue v. William Wrigley, Jr. Co.*, 505 U.S. 214; 112 S. Ct. 2447; 120 L.Ed.2d 174 (1992); this case is still good law. The prior Letter did not rely on a unitary analysis. Taxpayer has

always filed consolidated tax returns. The statutes and regulations have not changed. Therefore, the analysis in the prior Letter of Findings is still an applicable final ruling by the Department.

The Department's statutes, regulations, and policy directives set forth strict limits on the Department's ability to retroactively change the application of a prior ruling involving the same taxpayer, the same set of facts and issues. The standards are set forth generally at 45 IAC 15-3-2. 45 IAC 15-3-2(d)(3) specifically sets forth the extent to which a taxpayer may rely on a prior ruling:

> (3) In respect to rulings issued by the department, based on a particular fact situation which may affect the tax liability of the taxpayer, only the taxpayer to whom the ruling was issued is entitled to rely on it. Since the department publicizes summaries of rulings which it makes, other taxpayers with substantially identical factual situations may rely on the publicized rulings for informational purposes in preparing returns and making tax decisions. Generally, department publications may be relied on by any taxpayer if their fact situation does not vary substantially from those facts upon which the department based its publication. If a taxpayer relies on a publicized ruling and the department discovers, upon examination, that the fact situation of the particular taxpayer is different in any material respect from that situation on which the original ruling was issued, the ruling will afford the taxpayer no protection and the examination will apply to all open years under the statutes. Letters of findings that are issued by the department, as a result of protested assessments, are to be considered rulings of the department as applied to the particular facts protested.

Pursuant to the two most important statements above, i.e., "only the taxpayer to whom the ruling was issued is entitled to rely on it," and "[l]etters of findings that are issued by the department, as a result of protested assessments, are to be considered rulings of the department as applied to the particular facts protested," taxpayer was entitled to rely on the previous Letter of Findings in continuing to file consolidated returns that did not throw back sales to Indiana.

Tax policy directive #9, effective since December 1995, sets forth the time limits on reliance: "a departmental ruling will automatically become null and void and no longer of any effect for tax years beginning after December 31 of the sixth (6^{th}) year after the year in which the ruling is issued." In conjunction with 45 IAC 15-3-2(c) and (d)(2), Tax Policy Directive # 9 states in relevant part:

> A ruling may become null and void prior to the end of the six (6) year period given above under the appropriate circumstances. For instance, a change in the Department's position, a change in the tax laws, or a change due to a final court decision may cause a revocation of a ruling. The revocation of the ruling will be effective on the following dates:
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> (1) The date of the notice sent by the Department to the taxpayer to whom the ruling was issued that the Department's position has changed.

(2) The effective date of a change in the statutory law or a change in the rules interpreting the statutory law.
(3) The beginning date of the open tax year to which a final court decision applies.

Revocations can be applied retroactively "under the appropriate circumstances." Such revocations are made on a case-by-case- basis "taking into account all relevant facts and circumstances." The following circumstances are not all-inclusive: misstatement or omission of material facts by a taxpayer or his representative in the original request for a ruling; the facts, as developed after the ruling, turn out to be materially different from the facts on which the department based its original ruling; taxpayer's lack of good faith; incorrect interpretation of the law. Under the foregoing circumstances, a ruling "would be revoked retroactively and treated as if it had never been issued."

45 IAC 15-3-2(c) and (d)(2) provide in relevant part:

(c) As a general rule, the modification of a rule will not be applied retroactively. If a rule is later found to be inconsistent with changes in the law by statute or by decisions of a court of precedence, the rule will not protect a taxpayer in the same or subsequent years once the rule has been determined to be inconsistent with the law.
(d) (2) As a general rule, the revocation or modification of a ruling will not be applied retroactively with respect to the taxpayer to whom the ruling was originally issued or to a taxpayer whose tax liability was directly involved in such a ruling.

The regulation then goes on to repeat what can be found in Tax policy directive #9. Both the taxpayer in the present taxpayer protest and the auditor in the current audit state with authority that none of the factors set forth for retroactive application appear in the current protest.

It is the Department's considered decision that taxpayer was entitled to rely on the prior Letter of Findings for the entire six (6) years provided for by Regulation and Tax Policy Directive #9, until the publication of this Letter of Findings which finds that the Taxpayer has incorrectly interpreted the law for reasons set forth in Issue I.

FINDING

Taxpayer's protest concerning the assessment of additional adjusted gross income tax under Indiana's throw back rule is sustained because taxpayer was entitled to rely on a prior Letter of Findings which addressed the same set of facts and issues in a previous audit.

II. Adjusted Gross Income Tax-Numerator of the property factor

DISCUSSION

Taxpayer protests an alleged lack of consistency in the application of the adjustment for inventory obsolescence, and requests that the numerator of the Indiana property factor be adjusted on a proportionate basis to the adjustment relating to obsolete inventory made to the denominator of the property factor. The auditor relied on 45 IAC 3.1-1-44 to make an adjustment to the denominator, and stated that during the audit, taxpayer did not provide documents showing that taxpayer's calculations for its Indiana inventory included obsolescence. The auditor relied on the valuation method taxpayer used for Federal income tax purposes as the proper valuation to be used in the property factor.

45 IAC 3.1-1-44 provides that " [i]nventory is included in the property factor in accordance with the valuation method used by the taxpayer for Federal income tax purposes." Although taxpayer did not provide documentation to support its position during the audit, the suggestions made in taxpayer's protest letter and at the hearing indicate that the property factor should be re-examined:

> For the tax period in question (taxpayer) utilized the cost basis for purposes of determining the value of inventory used to calculate its Indiana property factor. During the audit, the auditor adjusted the denominator of (taxpayer's) property factor to reflect inventory obsolescence utilized to calculate inventory values for purposes of the Federal 1120 Schedule L Balance Sheet (see Audit Report, page 14). (Taxpayer agrees with the auditor's adjustment to the denominator of the property factor to reflect the their federal inventory valuation in accordance with 45 IAC 3.1-1-44. The inventory obsolescence adjustment relates directly to inventory maintained in (taxpayer's) Indiana warehouse. In doing so, the auditor adjusted the denominator of (taxpayer's) property factor to appropriately consider inventory obsolescence so as to tie the denominator of the property factor to the total inventory value reflected on the Federal 1120 Schedule L Balance Sheet. However, the auditor did not adjust the numerator of the property factor to reflect obsolescence related to inventory located in Indiana. This would result in an apportionment percentage of more than 100% as it relates to inventory for the company if all states' factors were totaled.

Subsequent to the hearing, taxpayer provided a type of balance sheet analysis of the property factor issue that supports another look at the original analysis.

FINDING

Taxpayer's protest is sustained subject to review by Audit.

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